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The U.S. Recovery: In Like a Lamb

Recently released data on the U.S. economy show that, although signs of recovery are clearly present, it is still too early to proclaim a boom. The persistence of rapid money growth since last summer had prompted a number of economists to forecast a first-quarter surge in real economic growth of 6% or more at an annualized rate—similar to the average rate of expansion in the early months of most previous recoveries. Preliminary data, however, from the Commerce Department's so-called "flash estimate" of January-March economic performance, project real growth of only 4%.

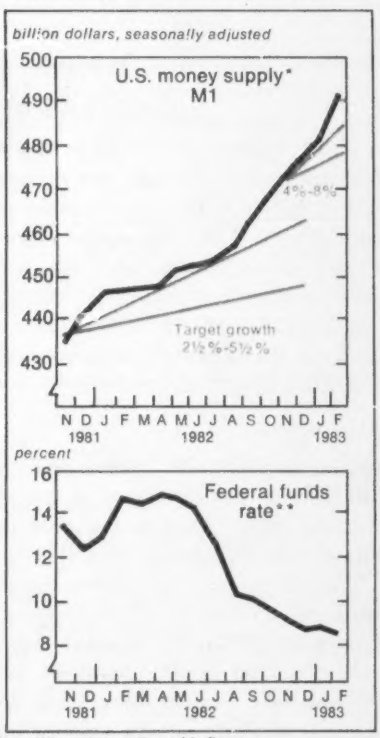
Other statistics suggest that even this less-than-robust growth is largely the result of a reduced rate of inventory liquidation. Retail sales declined in February for the third consecutive month, and business investment and exports remain on a downtrend. The only "boom" in the economy appears to be taking place in residential construction. The number of housing units started in January and February almost doubled the trough level reached early in 1982. (See page 4.)

One reason the pace of the current recovery may be slower than average is that interest rates seem stubbornly stuck on a relatively high plateau. Rising unemployment and a striking slowdown in inflation enabled the Federal Reserve to adopt a more accommodative stance in early October. And without the threat of the Fed tightening, interest rates fell sharply from their summer peaks, spurring the dramatic rebound in housing. Since then, however, three additional cuts in the discount rate have had little effect on the overall level of market interest rates except to steepen the yield curve beyond one year. This steepening reflects market expectations that: (1) the Fed will eventually respond to continuing above-target money growth by slowing the growth of reserves, or (2) inflation expectations will rise. Either would lead to higher interest rates.

In various speeches lately, Fed Chairman Volcker has hinted that the monetary authorities will be less tolerant of high money growth. This has once again raised fears of a Fed tightening. Interest rates have, in fact, moved up slightly in the past two weeks. Given the current state of the economy, any further rise in rates could damage the confidence of both consumers and businesses, and hence, threaten the incipient recovery.

A more restrictive stance by the Fed might well prove unnecessary if money growth slows in March and April, as seems likely with only a moderate rise in economic activity and continued low inflation. The markets would then be able to take rates lower without any aggressive easing by the Fed—moves that would inevitably risk rekindling inflation expectations.

U.S. money growth and short-term interest rates



*monthly average of weekly figures
**monthly average of daily figures

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Realignment in the European Monetary System.

After protracted and sometimes acrimonious negotiations–following weeks of speculative pressure–the EMS currencies were realigned on March 21. The German mark was revalued by 5.5%, while the French franc was devalued by 2.5%. Other changes included revaluations of 3.5% for the Dutch guilder, 1.5% for the Belgian franc, and 2.5% for the Danish krone–keeping its trade-weighted exchange rate almost constant. On the downside, the Italian lira was devalued by 2.5%. And the Irish pound–whose parity had been left unchanged since the formation of the EMS in 1979–despite Ireland's high rate of inflation, was devalued by 3.5%. Although France has asserted that the franc's devaluation was relatively small, from a world viewpoint, the change was clearly significant. And while the revaluation of the mark was essentially a revaluation in name only, this latest realignment has effectively depressed the whole EMS snake.

Declines in textiles and tourism lead to unemployment rise for Malta.

Malta has been inevitably hard hit by the current world recession. The textile sector, in particular, has faced declining product demand and increased competition from lower-cost producers. The value of textile and clothing production in the first three quarters of 1982 declined by 15% from that of the same period of 1980, contributing to a 20% drop in employment. Tourism has fallen off dramatically as well, with arrivals in 1982 down to only 50,000, more than 30% lower than the 1980 peak. On the whole, the economy has managed to sustain some growth –perhaps 2% for all of 1982–as a result of rising output in other specific manufacturing industries, expanded ship repair activity, and strong construction performance stemming largely from work on new port and dock facilities. Nevertheless, unemployment has been rising rapidly. Latest available figures show that joblessness climbed to 7.1% of the labor force last September, up from only 5% a year earlier. The government has responded by accelerating spending on additional new port facilities and other labor-intensive projects and by launching a pay and price freeze.

Turkish government forecasts further current-account improvement.

Official statistics suggest that Turkey made continued gains in its balance-of-payments position last year. Spurred by an undervalued exchange rate, 1982 exports grew by some 20% in dollar terms while imports remained flat. As a result, despite lower net invisible earnings brought on by higher interest payments on external debt and lower remittances from Turkish workers abroad, the current-account deficit halved in 1982 to an estimated $1 billion. This improvement occurred despite real GNP growth officially estimated at 4.4%, admittedly accompanied by a downturn in stockbuilding. For 1983, the authorities are forecasting a slight acceleration in real growth to 4.8% and another halving of the current-account deficit. In the longer term, however, Turkish authorities will have to guard against boosting domestic demand because of the attendant risks of catch-up import growth–if the high debt-service burden projected for 1984-85 is to be financed.

Outlook for Chilean economy remains bleak.

The Chilean economy suffered a severe 14% decline last year. A downturn in 1982 had been widely viewed as inevitable in light of the slowdown in foreign lending and continued world recession. However, the deterioration was much worse than had been anticipated because of an untimely devaluation in June that was followed by inconsistent economic policies. This stimulated speculative capital outflow and at the same time discouraged external borrowing. Chile lost some $1 billion in liquid reserves from June to December–twice the amount lost in the first half of 1982. The stepped-up demand for local funds, combined with the large reserve loss, resulted in even higher domestic interest rates. Chile lost an additional $400 million in the first two months of this year–an amount that would have been even higher if the IMF had not disbursed to the country about $490 million. In the absence of a substantial pickup in the industrial economies, the prospects for Chile in 1983 are not bright: Recovery will continue to be constrained by an untenable foreign-exchange position, accompanied by a crisis of confidence on the part of both local and foreign investors.

Panamanian economic growth expected to slow but remain positive.

Despite international recession and the decline of world trade in 1982, the Panamanian economy managed to achieve real GDP growth of about 3%. The forces behind the advance included greater activity and higher income from the Canal, rising construction expenditures for office buildings and the Petroterminals oil pipeline project, increased banana exports, and continued growth of the banking and insurance sectors. Activity was down, however, in the Colon Free Zone owing to the general Latin American slowdown, and wholesale trade and tourism fell below year-ago levels. The outlook for 1983 suggests an economy not as strong as in 1982. In a steady effort to contain the public-sector deficit, government expenditures are being held down and greater efforts are being made to generate fiscal income. Moreover, some of the larger construction projects have now been completed, and Free Zone activity remains depressed. As a result, the economy in 1983 is likely to record growth lower than the 1982 advance but still avoid an absolute decline.

Prospects for continued budget deficits may force Hong Kong government to change policies.

The Hong Kong government is expected to post a budget deficit of HK$3.9 billion in the fiscal year ending March 31—the first deficit in nearly a decade. The government in recent years has relied heavily on lucrative land sales to finance rapid public-sector spending increases. But the collapse of the real-estate market has resulted in an estimated HK$7.9-billion revenue shortfall. Faced with continued depressed property-sale earnings and an even larger budget deficit in the coming year, Financial Secretary Bremridge recently announced new indirect tax measures designed to raise some HK$3 billion. Overall spending is slated to show only a small increase in real terms. Still, a deficit of HK$3.2 billion remains to be financed out of reserves. So far, the financial secretary has ruled out borrowing to cover the shortfalls. But a continuation of these deficits even after the economy rebounds is highly possible and could force the government to change its fiscal policies—to increase corporate taxes, cut expenditures, or borrow—in order to cope.

Economic outlook for the Philippines shows promise.

The economy of the Philippines deteriorated noticeably in 1982: GDP growth slowed to 2.5% from 3.8% in 1981, and the current-account deficit swelled to nearly $3.4 billion—some 8.5% of GNP—from $2.3 billion in the previous year, largely owing to a 12.7% drop in exports. Long-term external debt climbed to almost $13 billion, bringing the debt-service ratio (World Bank definition) to 27%. This year, however, is already promising improvement. There have been significant increases in the prices of copper and coconut oil from last year's lows, and reduced oil prices will also be helpful. In addition, lower Eurodollar rates will save the Philippines several hundred million dollars in interest costs this year, while the signing of new agreements with the IMF and World Bank assures additional credits totaling $850 million. Finally, a new round of negotiations with the United States over military base rights is scheduled for this spring, and the Philippines will probably win substantial aid commitments.

Iranian budget plans large increase in development spending.

Despite a weakened world oil market and continued war with Iraq, the Iranian government's 1983/84 budget aims to give a new fillip to the domestic economy. The authorities have clearly demonstrated their desire to rebuild domestic productive capacity by boosting the allocation for development spending some 30%—to 1,200 billion rials from 922 billion rials in the previous fiscal year—with top priority apparently going to agriculture and heavy industry. At the same time, growth of current expenditures (excluding allocations for the Gulf War) has been held to 1% in an attempt to rein in inflation, which was running at an official year-on-year rate of 17% as of the third quarter of 1982. Government revenue forecasts in the new budget, however, are likely to be proved overly optimistic, inasmuch as they were based on oil-export projections averaging 2 million b/d at $30 per barrel. Given the latest OPEC agreement to cut prices and Iran's reported willingness to accept an overall output quota of 2.4 million b/d—and thus export volumes of only 1.9 million b/d—there is a likelihood that budget revenues will undershoot officially forecast levels even if oil market conditions stabilize.

A Solid Recovery for Housing

Thanks to the drop in interest rates from their summer peaks, residential real-estate activity is far and away the leading force in the U.S. economic recovery. In January and February, builders started construction of new housing units at a rate very nearly double that of the same months of 1982. Sales of existing houses have also improved substantially. And the beneficial results of this rising activity are being felt in other sectors of the economy as well.

A year ago, mortgage interest rates ranged upwards of 17%—a rate that is well outside what the financial status of the vast majority of Americans will bear. Moreover, mortgage money was scarce because of deposit outflows from the savings institutions that write the bulk of home mortgages. Interest rates began to come down—and savings deposit flows to improve—in the second half of 1982, however. Residential mortgage rates have recently been in the neighborhood of 13%.

New housing starts, which had fallen to an annual rate of less than 1 million in the first nine months of 1982, rose to 1.25 million for the last three months of the year, and passed 1.7 million this January and February. (For perspective, the average figure for the last five years of the 1970s was approximately 1.7 million units per year.) Sales of new houses have risen smartly and the inventory of unsold new homes fell to a 5½-month supply in January—as low as it has been in six years. Sales for existing homes are also up, by some 40% from their low point last summer. Families who move into existing houses frequently find themselves buying new furniture and household appliances in the process, and retail sales of appliances have indeed begun to improve after a long period of decline. Also as a result of the rise in housing starts, activity in the building-materials industries—which had been among the most depressed in the nation—has begun to stir.

It is unlikely that the recent pace of improvement can be sustained for long. For one thing, mortgage rates have recently backed up along with other rates. The increase has not been—and is not expected to be—great enough to put housing back in the doldrums at any time this year. But it may be enough to dampen some of the recent buying enthusiasm. In addition, it appears that the January-February figures on housing starts had the benefit of some special factors. The weather in January was not its usual beastly self this year, which made construction possible in some parts of the country where it is usually less active in the winter. And there was a sudden and probably temporary burst of multi-family starts in February. Even thus qualified, however, the recovery in residential real-estate activity—and its many suppliers—is a real one. Experts now generally forecast starts of as many as 1½ million units this year, for a gain of some 40% over the miserable 1982 total.

Richard W. Everett

Budget Woes Haunt the Muni Market

The municipal-bond market is gearing up to handle another year of heavy volume of tax-exempt offerings this year, as state and local governments continue to undergo significant fiscal strain. Fortunately, the market seems willing and able to assume the task. But a large volume of refundings and new issues—amid mounting concerns over credit quality and liquidity—could keep strong upward pressure on yields of muni notes and bonds.

Depressed revenues and higher spending demands last year forced state and local governments to boost their borrowing by 43% over 1981 levels, to a record $122 billion. For long-term general-obligation issues alone, the increase was 65%. To be sure, much of the revenue shortfall stems from the recession. But, while the recovery will provide some relief from these cyclical pressures, it will not alleviate the burdens caused by other forces of a longer duration.

The first of these is the changing structure of the economy. The industrial sector seems to be contracting to a more-compact—if more-efficient—size, leading in some areas to permanently closed plants and reduced employment. For many state and local governments, this decline of heavy industry will erode the tax base while spurring expenditures on the unemployed. Over time, new industries will emerge and redundant workers will develop new skills. But in the interim, state and local governments will have to do more with less.

Another force affecting the budget planning—and borrowing ability—of these governments is the effort by the Reagan administration to create a "New Federalism," transferring many federal functions to the states and municipalities. While this attempt is temporarily on the back burner, it is not a dead issue and the markets are somewhat wary.

A third strain on state and local government finances results from high rates of interest, still close to historical peaks. During 1982, rates on new 10-year AA general-obligation bonds averaged 9.69%—far above the average rates of 6.85% in 1980 and 5.63% in 1975. As state and local governments accumulate new debt or roll-over old issues, more of their limited resources will go to debt servicing, a trend they can ill-afford.

Thanks to a number of market innovations—which have greatly increased the attractiveness of tax-free municipal securities to investors—the market appears willing and able to absorb the heavy flow of debt issues that will result from these forces. These innovations include the greater availability of mutual funds, unit trusts, and insured securities, which have served, respectively, to increase liquidity, to allow for diversification with a set maturity and yield, and to reduce credit risk for investors. The combination is likely to prove attractive enough to lure funds sufficient to meet prospective borrower needs. But the price will be municipal yields that remain historically high relative to rates on taxable debt.

Vincent Salvo

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate△	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	March 23, 1983		current monetary conditions	
Austria	Economic conditions set to improve with recovery in rest of Europe.	Oct.	−4%	65.8	0	Jan.	4,921	− 2%	3.1	0	Current account now in surplus—exchange rate remains undervalued.	Feb.	+ 4%	Dec.	+ 8%	3.75%	.0595	Interest rates reduced in line with German cuts.	Austria
Belgium	Government seeks further spending cuts to reduce public-sector deficit.	Oct.	0	97.1	−2.0%	Jan.	4,279	− 3%	1.0	0	Trade deficit narrowed sharply in second half of 1982.	Jan.	+ 8%	Sept.	+ 7%	11.00%	.0209	Interest pressure eases after EMS adjustment.	Belgium
Britain	March 15 budget injects £2 billion and prompts official forecast of 2% growth in 1983.	Jan.	+2%	505.8	−2.0%	Jan.	10,838	−27%	1.3	0	Market surprised by Jan. current-account deficit; return to deficit still expected.	Feb.	+ 5%	Dec.	+11%	10.56%	1.4645	Bank base rates cut; new money growth targets announced.	Britain
Denmark	Little improvement expected this year from 1982's 1.5% growth.	Nov.	+6%	55.9	−0.2%	Jan.	2,925	+27%	2.2	0	Jan. saw first trade surplus in 16 months owing to lower imported oil costs.	Feb.	+ 9%	Sept.	+11%	8.50%	.1162	Discount-rate cut after EMS adjustments.	Denmark
Finland	Growth expected to pick up in 1983, following 1982's poor performance.	Nov.	0	48.3	+1.4%	Jan.	1,511	+19%	1.3	16	Analysts hope for a small current-account surplus this year after 1982's deficit.	Jan.	+ 8%	Oct.	+20%	8.50%	.1838	Money markets remain closely regulated.	Finland
France	No upturn seen for near future; further austerity measures likely.	Jan.	−1%	568.5	+0.3%	Jan.	19,476	− 5%	2.1	0	Trade deficit sharply wider in Jan.; 1983 goal to narrow gap to FF 45 billion.	Jan.	+10%	Oct.	+15%	9.50%	.1380	Franc devalued in EMS.	France
Germany	Leading indicators turn up during November-January period; recovery likely in latter 1983.	Dec.	−4%	685.5	−0.2%	Jan.	46,157	+11%	3.7	0	Current-account surplus to rise owing to falling oil prices.	Jan.	+ 4%	Dec.	+ 7%	4.00%	.4124	Key interest rates cut by one percentage point.	Germany
Ireland	Tough budget announced in Feb. will prevent any significant growth in output this year.	Aug.	−3%	16.2	+1.1%	Nov.	2,309	−15%	2.9	0	Current-account forecast revised to show 1983 deficit of 500 million Irish pounds.	Jan.	+12%	Oct.	+10%	14.00%	1.3000	First devaluation since formation of EMS.	Ireland
Italy	Economic indicators remain lacklustre; real GNP likely to remain flat in 1983.	Jan.	−5%	350.6	−0.2%	Jan.	15,258	−21%	2.3	0	Trade deficit widens in January, but set to decline soon.	Jan.	+16%	Sept.	+15%	19.00%	.000694	Large public-sector deficit keeping interest rates high.	Italy
Netherlands	Prospects raised for further fiscal tightening; real consumption spending likely to decline this year.	Nov.	−6%	137.9**	−0.8%**	Jan.	11,002	+24%	2.1	0	Current-account surplus looks set to widen further in 1983.	Jan.	+ 4%	Nov.	+ 6%	3.50%	.3774	Guilder remains strong member of EMS; interest rates cut.	Netherlands
Norway	Lower oil prices may force some policy changes, but economy expected to be flat.	Nov.	−2%	55.6	+0.8%	Jan.	6,620	+10%	5.3	0	Reduced oil revenues likely to push Norway into deficit this year.	Feb.	+10%	Oct.	+ 8%	9.00%	.1386	Interest rates, exchange rates remain steady.	Norway
Portugal	April 25 election continues to create uncertainty.	Aug.	+9%	23.5*	+5.5%*	Dec.	449	−17%	0.6	3	Current-account deficit for 1982 estimated at $3.2 billion.	Nov.	+19%	Aug.	+12%	23.00%	.0100	Last October M2 growth was 30.3%, year on year.	Portugal
Spain	GDP growth in 1982 was 1.3%.	Oct.	−1%	183.7	+0.3%	Dec.	7,655	−29%	3.2	5	Current-account deficit expected to fall below $3 billion.	Jan.	+14%	Nov.	+13%	8.00%	.0074	M3 target for 1983 set at 13%.	Spain
Sweden	Government hopes for export-led growth in wake of last October's devaluation.	Nov.	−1%	111.5	−0.7%	Jan.	3,390	0	1.5	0	January saw kr 100 million trade deficit, vs. 930 million year earlier.	Jan.	+10%	Dec.	+10%	9.00%	.1331	Interest rates cut by 1% end-January.	Sweden
Switzerland	No growth is expected in 1983.	Sept.	−6%	99.4	+2.0%	Jan.	12,751	+16%	5.5	0	Current-account surplus expected to widen from last year's $3.4 bn. figure.	Jan.	+ 5%	Nov.	+38%	4.00%	.4854	Franc slipped against DM in anticipation of EMS realignment.	Switzerland
Turkey	Real growth—officially estimated to have been 4.4% in 1982—expected to continue this year.	n. a.	n. a.	60.0	+4.4%	Dec.	923	−28%	1.3	1,515	Current-account deficit for 1982 halved to almost $1 billion.	Dec.	+33%	Dec.	+23%	31.50%	.0051	Money growth accelerating.	Turkey
Canada	Sluggish economic activity persists; strong pick-up awaits recovery in the U.S.	Nov.	−6%	283.6**	−4.8%**	Jan.	3,341	− 4%	0.7	0	Greater fall in imports relative to exports yielded current-account surplus in '82.	Feb.	+ 7%	Dec.	+ 4%	9.47%	.8155	Fears of renewed inflation keep policies conservative.	Canada
United States	Housing boosts economy sharply, although other sectors remain weak.	Jan.	−3%	3,057.5**	−1.8%**	Jan.	22,791	+20%	1.1	0	Current account slid into $8.1 billion deficit in 1983, further deterioration likely.	Jan.	+ 4%	Feb.	+10%	8.50%	—	Rapid money growth continues, credit markets nervous.	United States

*1980 **1982 △most recently reported

World Interest Rates

market rates as of March 23, 1983; bond yields as of March 18, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.47	10.563 intervention rate	11.00	9.50	4.00	19.00 penalty rate 22.00	3.50	4.00	5.50
Day-to-Day Money	8.75 March 24	9.25	10.75	7.35	12.875	5.05	19.25	4.25	3.00 1-month Euro-Swiss fr. rate	6.625
Treasury Bills 91-day, Middle Rates	8.45	9.15	10.219	12.25	n. a.	n. a.	17.352 63 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.875 finance paper discount basis	9.30 finance paper 15% tax w/h	10.062	13.90 Certified	12.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.75	9.25 15% tax w/h	10.281	13.90 Certified	not traded	5.00	19.30	no market	4.00	no market
Government Bonds Long-term, new and old issues, average yield	10.90	12.05	10.67	10.61	13.91	7.40	18.84	7.78	4.43	7.461*
Industrial Bonds prime, long-term, new and old issues, average yield	11.65 Aa Industrials	12.80	12.35	12.29	15.00	7.50	18.25	8.13	5.89	6.45*
Bank Short-Term Rate (prime rate)	10.50	11.50	10.50	18.00	14.55	8.00	20.00 ⅛ qtrly fee on outstdng.	6.00	7.50	6.00
Bank Time Deposits 3-month	8.80 Cert. of Dep.	9.25	10.813	12.50	12.688	5.10	11.50	4.50 large deposits	2.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.75	9.688	10.875	no market	14.25	5.00	no market	4.125	4.00	6.75
Exchange Rates—in U.S.$ rates floating against the $	—	.8157	1.4625	.0209	.1377	.4126	.0007	.3679	.4815	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.049 *P*	0.985 *D*	3.484 *D*	4.648 *D*	4.944 *P*	10.405 *D*	5.545 *P*	5.815 *P*	2.959 *P*

Eurodollar Deposits
(London, interbank, bid)
March 24

7-day	9.688
1-month	9.438
3-month	9.500
6-month	9.625

International Arbitrage
(3-month, hedged)
+ in favor of U.S. dollars

U.S.-U.K. Treasury Bills	−0.644
U.S.-Canada Treasury Bills	−0.422
U.S.-Canada Finance Co. Paper	−0.347
Eurodollars-U.K. Local Auth. Deposits	−0.015

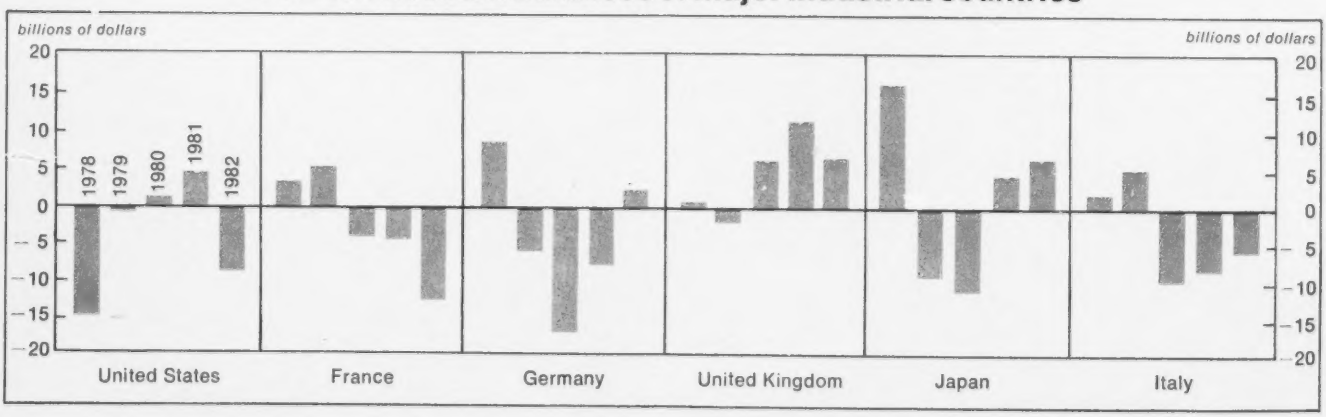
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.00
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	7.50
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
410.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Bond yields as of March 11.

Current-account balances of major industrial countries



Capital Investment Boom: Not Now but Later

For sustained global recovery, there must be a major revival of capital investment. As the last issue of *International Finance* (March 14) pointed out, falling world oil prices are already having both positive and negative effects on capital spending. While it is difficult to predict what the overall impact of the oil-price drop will be, it is possible to identify the major elements of change.

On the negative side, increased price uncertainty, a possible reversal of plant obsolescence, and a decline in the average project scale all may tend to reduce the overall level of capital investment—at least during a transitional period.

- For the first time in over a decade, there exists a serious downside risk for relative energy prices, in spite of the compromise on oil prices and production reached by the members of OPEC earlier this month. This raises the level of uncertainty over future returns on investments in energy production and conservation. One of the reasons global investment spending held up well into the past recession was that the expected rate of return from energy investments and energy conservation exceeded the rising real rate of interest. As the table below shows, U.S. and Japanese private non-residential investment grew moderately in 1981. In fact, the drop did not occur until the second half of 1982. Now, many energy-related projects will realize lower returns than expected since, overinvestment in such activities undercut the expected path for real energy prices.
- The decline in energy prices will also influence the criteria for scrapping existing capital by making some processing and manufacturing capacity once more profitable to operate. This will tend to reduce any derived demand for new construction, as capacity utilization rates increase during the recovery.
- Finally, the decline of revenues earned by energy companies and oil-exporting nations will affect those recently prominent in contracting large-scale projects around the world. Many of these projects will now be either canceled entirely, stretched out, or scaled down. Moreover, the revenue gains of other industries and countries will not immediately evoke equivalent contracting for large projects. Instead, smaller contracts for replacement equipment, general-purpose machinery, transport equipment, and modernizing construction are likely to appear. Thus, there may be a transitional drop in total demand for fixed capital and a shift away from plant construction toward machinery.

Outlook for capital investment
(percentage change from previous year)

	1981	1982	1983	1984
United States				
Private fixed investment	1.7	− 6	2	8½
Private residential	−4.9	−10	25	10
Private non-residential	3.5	− 5	− 2	7½
Japan				
Fixed investment	2.1	− ¾	1¾	3
Public	4.7	0	− ½	− 2
Private residential	−1.1	− ¾	5	5
Private non-residential	1.7	− 1	2	5
Germany				
Fixed investment	−3.8	− 6½	1½	2½
Public	−7.7	−10	0	2½
Private residential	−4.0	− 7½	3	2
Private non-residential	−2.7	− 5	1½	2½

Data: OECD; Chase forecasts for 1983, 1984

To offset these negative influences, lower oil prices are also likely to have a number of positive effects on capital spending, as a result of—among other things—the complementarity of capital and energy in production, declining nominal interest rates, and the so-called "investment accelerator."

- The evidence of the past decade, when energy prices were rising, suggests that capital and energy are complementary inputs in production, while capital/energy combinations are substitutes for labor. Consequently, lower relative energy prices should encourage a shift away from labor-intensive production techniques back toward capital/energy-intensive methods, stimulating purchases of capital equipment.
- At the same time, reduced oil prices will inevitably help to calm inflation expectations and eventually bring down nominal interest rates. Because this might not be sufficient to reduce real rates of interest, investment in machinery and plant may be unaffected. However, falling nominal rates have already raised the real wealth of households and stimulated residential investment. And this should help to offset the stagnation or decline in non-residential fixed investment expected in the largest OECD economies this year.
- Finally, the impact of what economists refer to as the "classical accelerator model"—which relates investment to underlying growth in output—should dominate all other capital-investment effects by 1984. Expectations of a more-rapid recovery in the OECD and the prospect of sustained real growth through the mid-1980s will increase the optimal level of capital stock for most enterprises. As firms adjust toward this higher target, capital spending will eventually rise faster than the expected growth of aggregate demand.

Thus, the outlook for capital spending suggests that after a transitional period of perhaps six months to a year, when investment may actually be less than if oil prices had held steady, a strong surge in orders and expenditures for capital goods can be expected for 1984-85. Of course, the principal risk to such an investment rebound would be the failure of real interest rates to decline from present levels. *Donald W. Green*

U.S. Firms 'Discover' the Eurobond Market

For U.S. corporations, 1982 clearly represented the year the international bond markets came of age. Gross proceeds from Eurobonds and foreign bonds issued by U.S. companies last year totalled nearly $15 billion—more than double the just-under $7 billion in 1981.

Last year's activity also illustrated that market conditions in international and U.S. domestic bond markets often differ, providing corporate treasurers two different new-issue "windows" to tap for long-term funds. For example, in 1982, the volume of new corporate bond issues in the American market was depressed until August, while in the Eurobond market, the volume of new issues by U.S. corporations reached record highs in the first five months of the year.

Such differences can be explained, at least in part, by three forces. First, the Eurobond market last year proved much more "innovative" than its domestic dollar counterpart through the use of such features as zero-coupons, bond warrants, and partly-paid issues. These innovations often attracted new investors and provided issuers with a relatively cheap source of funds.

Another reason for the divergence of activity in the Euro- and U.S.-bond markets was that until early last year, American corporations had to go through time-consuming registration procedures to issue bonds in the domestic market, while an issuer could tap the Eurobond market with virtually no lead time. And although the Securities and Exchange Commission's passage of Rule 415 in early 1982—allowing the so-called "shelf registrations"—enabled issuers to tap the U.S. markets almost instantaneously, it took a while for firms to take advantage of this rule.

A third force affecting the two markets in 1982 was a shift in the demand of foreign investors for dollar-denominated bonds relative to that of U.S. investors. During much of 1982, even when the domestic bond market was in the doldrums, the foreign-investor demand for these bonds rose sharply—in large part reflecting their beliefs both that U.S. interest rates would fall and that the dollar would weaken against the yen, mark, and Swiss franc. However, owing in part to the withholding-tax laws in their own countries, these investors preferred to hold Eurodollar bonds rather than domestic U.S. bonds. As a result, the demand for Eurodollar bonds rose relative to that for U.S. bonds, driving down relative Eurobond rates. Lured by the cheaper source of financing, American companies issued Eurobonds in record numbers. And eventually the yield advantage vanished—albeit with somewhat of a delay.

Clearly, the international bond markets will continue to provide U.S. corporations with an additional source of long-term funds in the future. However, the growth in the use of this market in 1983 will probably be somewhat more moderate than in 1982. One of the reasons for this is that, at present, the yield advantage issuers gain by tapping the Eurobond market has disappeared. Moreover, the growth and maturation of the markets—and the increase in the number of potential issuers—suggests that such yield differentials are less likely to occur in the future—and certainly not for as extended a time.

Another reason to expect slower growth is that American firms have become more comfortable with shelf registrations and have been increasingly using them to tap the domestic bond market. U.S. companies are also raising funds in the equity market at an extraordinary pace, taking advantage of the optimism imbedded in current high stock prices.

Even if such slower growth occurs, however, it seems clear that the international bond markets are now too important for U.S. corporate treasurers—or credit market analysts—to ignore. *Thomas A. Lawler*

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	**IVQ/81**	**IQ/82**	**IIQ/82**	**IIIQ/82**	**1979**	**1980**	**1981**
Gross Size (Claims)	1,550.2	1,559.2	1,570.9	1,627.1	1,111.0	1,321.9	1,550.2
Net Size (Claims)	945.0	945.0	965.0	985.0	665.0	810.0	945.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	303.2	303.8	310.4	311.6	269.7	287.5	303.2
Liabilities to Private Nonbank Foreigners	94.3	97.0	105.7	107.1	65.9	75.0	94.3
Total Claims on Foreigners	445.7	457.0	469.9	480.5	324.2	385.4	445.7
Claims on Foreign Public Borrowers	59.4	60.0	65.3	67.0	42.0	48.9	59.4
Claims on Foreign Private Nonbank Borrowers	161.3	162.8	165.2	166.7	117.8	139.9	161.3

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.
Source: Chase Manhattan Bank estimates based on BIS and national data sources.